State may seek recovery of the annual amortization of the acquisition premium in future proceedings to the extent offset by merger-related savings. As noted above, the Petitioners bear the burden of demonstrating the presence of merger-related benefits to the Department before any portion of this acquisition premium may be included in Bay State's rates. Because the stock exchange, when it occurs in fact, will be based on the actual number of Bay State shares outstanding on the consummation date as well as NIPSCO Industries' stock price used in the merger agreement, the actual amount of the acquisition premium cannot be precisely calculated until the consummation date or shortly thereafter -- although its range is formulaically determined. The Petitioners are hereby directed to provide the Department with a copy of the journal entries or a schedule summarizing such entries upon completion of the merger, in sufficient detail so as to determine the actual acquisition premium. Additionally, the Petitioners are directed to provide the Department with a detailed listing of the final transaction costs 90 days from the date of consummation of the merger.

Throughout this proceeding, the Petitioners have repeatedly represented that Bay State ratepayers would bear no risk for recovery of the acquisition premium during the five-year rate freeze (Tr. 2, at 129, 135-136; Petitioners' Brief at 17; Petitioners' Reply Brief at 3). This repeated representation is one to which NIPSCO Industries and Bay State will fairly be held throughout the period of the Rate Plan.

D. Financial Integrity of Post-Merger Gas Company

1. Introduction

The Petitioners contend that the merger will have no adverse effects on Bay State's financial integrity and will provide Bay State with additional financing options under more favorable terms than are now available to that company (Petitioners Brief at 34). Petitioners claim that NIPSCO Industries' debt management program provides financing flexibility in such matters as terms and debt maturity. The debt management program is intended to allow ready responses to interest rate changes (Exh. AG 2-16 (supp) at 2).

2. Analysis and Findings

The Department has stated that the financial integrity of a company may be one of the factors considered in evaluating a merger petition. Mergers and Acquisitions at 8-9. Under the Preferred Merger, Bay State would remain a stand-alone company operating as a wholly-owned subsidiary of NIPSCO Industries. A review of Bay State's financial and operating data, as represented by its annual returns to the Department,[45] SEC, and shareholders, as well as information provided in Bay State's disclosure statements and developed through NIPSCO Industries' evaluation of the proposed merger, demonstrates that Bay State is financially viable (Exhs. AG 1-1 (A); AG 1-2; AG 1-8; AG 3-9 (Proprietary)). Moreover, Bay State's post-merger financial position is likely to improve because of the additional sources of capital open to Bay State through its affiliation with NIPSCO Industries. Such an improvement would result in benefits to ratepayers (Exh. AG 2-16 (Supp.)). Accordingly, the Department finds that the Preferred Merger will not adversely affect Bay State's financial integrity, absent the effects of the deferral of recovery of the acquisition premium. See section IV C(3), above.

Under the Alternative Merger, Bay State would become a division of Northern Indiana. A review of Northern Indiana's financial and operating data contained in its annual reports to both the Federal Energy Regulatory Commission and the SEC, and a review of NIPSCO Industries' annual returns and disclosure statements provided to its shareholders, demonstrates that Northern Indiana is also financially viable (Exhs. AG 1-1 (B); AG 1-3; AG 1-7; AG 1-9). There is no evidence that Northern Indiana's or Bay State's facilities require extraordinary investments, or that the financial viability of either company is in doubt. Cf. Community Utilities/Resort Supply, D.P.U. 16380, at 2-5 (1970) (Department disallowed proposed merger of two small water systems because of, in part, concerns over the financial viability of both systems). Finally, Bay State's ratepayers may benefit through NIPSCO Industries' additional sources of capital available to Northern Indiana (Exh. AG 2-16 (Supp.)). Accordingly, the Department finds that the Alternative Merger will not adversely affect Bay State's financial integrity.

E. Societal Costs

1. Introduction

The Petitioners stated that in considering the merger, they did not seek a combination that would require employee reductions at either Bay State or NIPSCO Industries in order to generate lower costs and greater short-term earnings (Exh. Cos.-A, at 13; Cos.-B at 11). Instead, the Petitioners view the acquisition of Bay State by NIPSCO Industries as a "strategic merger" that would use Bay State's existing workforce to increase throughput and improve service to customers (Exhs. Cos.-A at 13; Cos.-B at 13). The Petitioners stated that under both the Preferred Merger and Alternative Merger, Bay State would maintain its Westborough headquarters, as well as its existing local offices in Brockton and Springfield (Tr. 2., at 97). The Petitioners noted that although any consideration of workforce reductions here would be premature, future workforce reductions that may occur as a result of cost

containment efforts would be worked out through negotiation with the employees' respective bargaining units (Tr. 2, at 100). The intervenors did not address this issue on brief.

2. Analysis and Findings

The Department does not lightly regard the effect of mergers on employment. Eastern-Essex Acquisition at 44. Although job redundancies in consolidated systems would impose avoidable costs and thus would be detrimental to ratepayers, the Department has noted that the elimination of these redundancies should be accomplished in a way that mitigates the effect on the utility's employees. Eastern-Essex Acquisition at 43.

Bay State has already engaged in significant cost containment efforts, and savings have resulted from workforce reductions (Exh. Cos.-B at 11-12; Tr. 2, at 94, 97-99). Moreover, NIPSCO Industries' assessment of the growth potential in Bay State's service territory and expressed intent to avoid layoffs at Bay State demonstrate that the Petitioners consider a strong local presence and management at Bay State to be a critical component of the combined system's long-term objectives (Exh. Cos.-B at 13; Tr. 2, at 94-95). The Department concludes that neither the Preferred Merger nor the Alternative Merger would significantly affect Bay State's workforce.

F. Stock Issuance

1. Introduction

Acquisition Company is intended to have an authorized capitalization of 1,000 shares of common stock, $1.00 par value, of which 100 shares have been subscribed for sale to NIPSCO Industries at a price of $1.00 per share (Exh. DTE 1-7 (Supp.)). The Petitioners request that the Department authorize and approve the proposed issuance of 100 shares of this common stock to NIPSCO Industries, at a price of $1.00 per share (Petition at 1). The Petitioners state that the proposed issuance is reasonably necessary to effect the merger (id. at 6). While the Petitioners restated their request in their brief, the Attorney General did not address this issue on brief.

2. Standard of Review

In order for the Department to approve the issuance of stock, bonds, coupon notes, or other types of long-term indebtedness[46] by an electric or gas company, the Department must determine that the proposed issuance meets two tests. First, the Department must assess whether the proposed issuance is reasonably necessary to accomplish some legitimate purpose in meeting a company's service obligations, pursuant to G.L. c. 164, § 14. Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 395 Mass. 836, 842 (1985) ("Fitchburg II"), citing Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 394 Mass. 671, 678 (1985) ("Fitchburg I"). Second, the Department must determine whether the Company has met the net plant test.[47] Colonial Gas Company, D.P.U. 84-96 (1984).

The Court has found that, for the purposes of G.L. c. 164, § 14, "reasonably necessary" means "reasonably necessary for the accomplishment of some purpose having to do with the obligations of the company to the public and its ability to carry out those obligations with the greatest possible efficiency." Fitchburg II at 836, citing Lowell Gas Light Company v. Department of Public Utilities, 319 Mass. 46, 52 (1946). In cases where no issue exists about the reasonableness of management decisions regarding the requested financing, the Department limits its Section 14 review to the facial reasonableness of the purpose to which the proceeds of the proposed issuance will be put. Canal Electric Company, et al., D.P.U. 84-152, at 20 (1984); see, e.g., Colonial Gas Company, D.P.U. 90-50, at 6 (1990).

The Fitchburg I and II and Lowell Gas cases also established that the burden of proving that an issuance is reasonably necessary rests with the company proposing the issuance, and that the Department's authority to review a proposed issuance "is not limited to a 'perfunctory review.'" Fitchburg I at 678; Fitchburg II at 842, citing Lowell Gas at 52.

Where issues concerning the prudence of a company's capital financing have not been raised or adjudicated in a proceeding, the Department's decision in such a case does not represent a determination that any specific project is economically beneficial to a company or to its customers. In such circumstances, the Department's Order may not in any way be construed as ruling on the appropriate ratemaking treatment to be accorded any costs associated with the proposed financing. See, e.g., Boston Gas Company, D.P.U. 95-66, at 7 (1995).

Regarding the net plant test, a company is ordinarily required to present evidence that its net utility plant (original cost of capitalizable plant less accumulated depreciation) is equal to or exceeds its total capitalization (the sum of its long-term debt, preferred stock, and common stock outstanding) and will continue to do so after the proposed issuance.

D.P.U. 84-96, at 5. If the Department determines at that time that the fair structural value of the net plant and land and the fair market value of the nuclear or fossil fuel inventories owned by the company are less than its outstanding debt and stock, it may prescribe such conditions and requirements as it deems best to make good within a reasonable time the impairment of the capital stock. G.L. c. 164, § 16.

3. Analysis and Findings

The Petitioners have requested that the Department authorize the issuance of stock to a corporation that is not yet in existence. While one could argue that G.L. c. 164, § 14, addresses stock transfers to corporate entities only, we recognize that some flexibility must be afforded to those petitioners that require stock transfers in order to form a corporation by way of a merger or acquisition. Here, the Petitioners request authority to issue stock in order to establish the framework within which the merger could be consummated. Without the authority to issue the stock, this merger would not take place. Therefore, the Department finds that the issuance of 100 shares of common stock by Acquisition Company, at a par value of $1.00, is a necessary mechanism for the purpose of forming Acquisition Company and effecting the proposed merger. Accordingly, the Department finds that the proposed stock issuance is reasonably necessary and is in accordance with G.L. c. 164, § 14.

With regard to the net plant test requirement of G.L. c. 164, § 16, the record demonstrates that Acquisition Company has no assets and thus could not meet the net plant test as contemplated by G.L. c. 164, § 16. However, the Department notes that the Merger Agreement would extinguish the corporate existence of Bay State. Through the acquisition of Bay State's assets, Acquisition Company would remedy any net plant deficiency of Acquisition Company. See Eastern-Essex Acquisition at 74; D.P.U./D.T.E 97-63, at 73. The purpose of the net plant test is to protect investors from hidden watering of stock. Application of the test was not contemplated for a transaction as patent and transparent as the instant one. No public protective purpose would be served by applying the test here. It is sufficient to note that the transaction is structured to prevent any adverse risk to the investing public and immediately to correct any theoretical problem with the Acquisition Company shares. Eastern-Essex Acquisition at 74. Therefore, the Department finds it unnecessary to impose further conditions upon Acquisition Company under G.L. c. 164, § 16.

G. Section 17A Approval of Funds Pooling Amendment

1. Introduction

In Bay State Gas Company, D.P.U. 96-69 (1996), the Department approved a funds pooling arrangement between Bay State, Northern, and Granite State, in which the participants pool their short-term cash surpluses and manage these funds to meet the borrowing needs of the participants (Exh. DTE 1-22). The Petitioners request approval of a modification to Bay State's funds pooling agreement to permit NIPSCO Capital, NIPSCO Industries' financing subsidiary, to participate (Petition at 6; Tr. 2, at 75).[48]

2. Standard of Review

Pursuant to G.L. c. 164, § 17A, a gas or electric company must obtain written Department approval in order to "loan its funds to, guarantee or endorse the indebtedness of, or invest its funds in the stock, bonds, certificates of participation or other securities of, any corporation, association or trust." The Department has required that such proposals must be "consistent with the public interest," that is, a Section 17A proposal will be approved if the public interest is at least as well served by approval of the proposal as by its denial. Bay State Gas Company, D.P.U. 91-165, at 7 (1992); see D.P.U. 850, at 7-8.

The Department has stated that it will interpret the facts of each Section 17A case on their own merits to make a determination that the proposal is consistent with the public interest. D.P.U. 91-165, at 7. The Department will base our determination on the totality of what can be achieved by, rather than on a determination of any single gain that could be derived from, the proposed transaction. Id.; see D.P.U. 850, at 7. Thus, the Department's analysis must consider the overall anticipated effect on ratepayers of the potential costs and benefits of the proposal. D.P.U. 91-165, at 8. The effect on ratepayers may include consideration of a number of factors, including, but not limited to: the nature and complexity of the proposal; the relationship of the parties involved in the underlying transactions; the use of funds associated with the proposal; the risks and uncertainties associated with the proposal; the extent of regulatory oversight on the parties involved in the underlying transaction; and the existence of safeguards to ensure the financial integrity of the utility. Id.

3. Analysis and Findings

As part of the Department's approval of Bay State's funds pooling agreement in

D.P.U. 96-69, the Department required that any amendment in the funds pooling agreement be approved by the Department prior to its implementation. D.P.U. 96-69, at 4-5. The Department has approved amendments to other funds pooling agreements, including the addition of additional participants to these fund pools. Nantucket Electric Company, D.P.U. 95-67, at 15-16 (1995); Massachusetts Electric Company, D.P.U. 91-133, at 4 (1992); New England Power Company, D.P.U. 88-166, at 2 (1989).

As noted in Section I (see note 2, above), NIPSCO Capital provides financing for most of NIPSCO Industries' regulated and unregulated subsidiaries under the terms of a support agreement ("Indiana Agreement") (Exh. Co.-B, Sch. MTM-2, at 26; Tr. 2, at 75). The Petitioners requested the inclusion of NIPSCO Capital in Bay State's funds pooling agreement, rather than the addition of Bay State and its subsidiaries as participants to NIPSCO Capital's current Indiana Agreement (Tr. 2, at 78). The Petitioners consider the Bay State funds pooling agreement to be more adaptable to Bay State's post-merger operations (Tr. 2, at 78). NIPSCO Capital currently has a $150 million revolving-credit agreement, that provides short-term financing flexibility to NIPSCO Industries' subsidiaries, plus $130 million in money market lines of credit (Exh. Co.-B, Sch. MTM-2, at 26). The addition of NIPSCO Capital as a participant to Bay State's funds pooling agreement would provide Bay State with the opportunity to gain access to these additional financing sources to meet its short-term borrowing needs. Conversely, given the status of NIPSCO Capital as a financing vehicle, NIPSCO Capital's own borrowings from the Bay State pool would be negligible. Therefore, the Department concludes that the proposed amendment to Bay State's funds pooling agreement, which will permit NIPSCO Capital to participate in the funds pooling agreement, is consistent with the public interest.

If the Alternative Merger is consummated, Northern Indiana would be the surviving company, with Bay State operating as a division of Northern Indiana (Exhs. Co.-A at 28-29; Co.-B, Sch. MTM-4, at A-1). Although Northern Indiana is not currently a participant in the Support Agreement (Tr. 2, at 75-76), by virtue of the Alternative Merger, Northern Indiana would be the successor in interest to all rights, privileges, immunities, and powers currently held by Bay State (Exh. Cos.-B, Sch. MTM-4, at A-1). Accordingly, the Department finds that if the Alternative Merger is ultimately implemented, Northern Indiana would become a participant in the funds pooling agreement.

The Petitioners stated that NIPSCO Industries' management is still evaluating the possibility of including Northern Indiana as a participant to the Indiana Agreement (Tr. 2, at 78-80). If the Alternative Merger is ultimately implemented, and NIPSCO Industries' management determines that it would be appropriate to include Northern Indiana as a participant to the Indiana Agreement, Department approval of Northern Indiana's inclusion may also be required under G.L. c. 164, § 17A. Therefore, the Petitioners are directed to notify the Department if NIPSCO Industries implements the Alternative Merger and later seeks to include Northern Indiana as a participant to the Indiana Agreement.

H. Northern Indiana Operating as a Massachusetts Gas Company

1. Introduction

Northern Indiana is an Indiana corporation organized as a combination gas and electric company doing business exclusively in Indiana (Exhs. Co.-B at 3; AG 1-1, Sec. 4.3, at 3). According to the Petitioners, G.L. c. 164, § 8A(a)[49] suggests that Northern Indiana may need Department approval to operate as a gas company in Massachusetts because of its status as an electric company in Indiana (Petition at 4). Therefore, Northern Indiana has requested authorization to engage in the business of a gas company in Massachusetts if the Alternative Merger is ultimately consummated (Petition at 7; Tr. 2, at 80-81).[50] The Petitioners stated that Northern Indiana does not intend to operate as a Massachusetts gas company if the Preferred Merger is ultimately implemented (Tr. 2, at 80-81). The Petitioners stated that, although Northern Indiana has not yet taken the required shareholder vote to amend its articles of organization, obtaining shareholder approval would not be difficult in view of Northern Indiana's status as a wholly-owned subsidiary of NIPSCO Industries (Tr. 2, at 81-83).

2. Standard of Review

In pertinent part, G.L. c. 164, § 8A, requires the Department, after notice and public hearing, to certify to the secretary of state that the public convenience will be promoted, permitting Northern Indiana to operate as a gas company in Massachusetts.

Because the statute does not define "public convenience," the Department relies on our precedents relating to "public convenience and necessity."

The Department has been accorded wide discretion in determining whether the "public convenience and necessity" would be promoted by some proposed action. Zacks v. Department of Public Utilities, 460 Mass. 217 (1985) Almeida Bus Lines, Inc. v. Department of Pub. Utils., 348 Mass 331 (1965); Holyoke St. Ry. v. Department of Pub.Utils., 347 Mass. 440 (1964); Newton v.

Department of Pub. Utils., 339 Mass. 535 (1959). "Public convenience and necessity" is a term of art that the courts have equated with "public interest". Zacks v. Department of Public Utilities, 460 Mass. 217, 223 (1985). Therefore, to determine whether to authorize a gas company to engage in the business of an electric company, or an electric company to engage in the business of a gas company, the Department will consider whether the requested action is in the public interest.

3. Analysis and Findings

Petitions under this statute and its predecessors[51] have historically been brought by gas companies seeking to operate electric systems. See, for example, Cambridge Gas Light Company, D.P.U. 3729 (1930). While the earlier G.L. c. 164, § 23, was replaced by certain provisions of G.L. c. 164, § 8A, no petitions under either the pre-1973 version of § 23 or the later § 8A have been filed with the Department since 1930. Moreover, Department records indicate that this is the first time that a non-Massachusetts gas or electric company (as distinct from common carriers) has sought to acquire or merge with a Massachusetts utility (holding companies, of course, are distinct). Thus, the matter before us is one of first impression.

The entrance of foreign corporations in the Massachusetts gas and electric industries previously raised concerns over the legal status of foreign corporations operating gas and electric systems within Massachusetts; and foreign ownership was not favored. Third Annual Report of the Board of Gas and Electric Light Commissioners at 58 (1888). The enactment of the Restructuring Act[52]("Act") revised the definition of a "gas company" or "electric company" set out in G.L. c. 164, § 1, to include non-Massachusetts corporations operating gas or electric utilities within Massachusetts.[53] The Act gives the Department the same jurisdiction over foreign utilities operating in Massachusetts as is currently applied to Massachusetts-chartered corporations. Therefore, there is no longer a bar on "foreign" corporations operating gas or electric systems within Massachusetts. The Department considers that approval of Northern Indiana's request to operate as a Massachusetts gas utility would facilitate a contingency merger proposal that has been found to be consistent with the public interest. Because the Department has equated "public interest" with "public convenience," for the reasons described above, the Department finds that the public convenience would be promoted by an amendment to Northern Indiana's articles of incorporation that would permit it to operate as a gas utility in Massachusetts.

Northern Indiana's articles of incorporation currently restrict that company to operating only within Indiana (Exh. AG 1-1, Sec. 4.3, at 3). Although Northern Indiana has not yet made the shareholder vote necessary under § 8A to permit operations in Massachusetts, the Petitioners represent that the required vote will be readily obtained because Northern Indiana is a wholly-owned subsidiary of NIPSCO Industries (Tr. 2, at 81-83). Because § 8A does not require that the shareholder vote take place prior to Department certification, the Department finds that approval may be granted, contingent upon the required vote of Northern Indiana's sole shareholder, NIPSCO Industries and accordingly, gives this approval. The Petitioners are directed to submit a copy of the shareholder vote to amend Northern Indiana's articles of organization and revised articles of organization, if and when such a vote is taken.[54]

Northern Indiana's request to operate as a Massachusetts gas company also raises the issue of the corporate name under which Northern Indiana would operate. G.L. c. 164, § 5A, requires that the name of a utility corporation operating in Massachusetts contain the words "gas company" or "electric company," as the case may be. The Petitioners indicated that, if the Alternative Merger is ultimately implemented, Northern Indiana would operate in Massachusetts under a d/b/a arrangement as "Bay State Gas Company" in order to capitalize on customer familiarity with Bay State and thereby avoid customer confusion (Tr. 2, at 86). Based on a review of G.L. c. 156B and c. 164, the Department concludes that there is no statutory bar against the use of an assumed name by Northern Indiana.[55] Additionally, the Department finds that the continued use of the Bay State corporate name by Northern Indiana for its potential Massachusetts operations would reduce the possibility of customer confusion resulting from the merger. Accordingly, the Department finds it appropriate for Northern Indiana to operate under Bay State's name, if the Alternative Merger is ultimately consummated.

Northern Indiana would only operate as a Massachusetts gas company if the Alternative Merger is implemented (Tr. 2, at 80-81). If the Preferred Merger is ultimately implemented, Northern Indiana's need to operate as a Massachusetts gas company would be rendered moot (Tr. 2, at 68). The Petitioners themselves have made the request for Northern Indiana to operate as a Massachusetts gas utility only to facilitate an Alternative Merger proposal

(Exh. Cos.-A, Sch. MTM-4, at A-1; Tr. 2, at 80-81). Therefore, the Department's approval of Northern Indiana's request to operate as a Massachusetts gas utility is contingent upon the consummation of the merger under the Alternative Merger proposal.

In view of the possibility that the Preferred Merger may be ultimately implemented, the Department finds it appropriate to place a time limit on the authority being granted by this order to Northern Indiana. See Berkshire Gas Company, D.P.U. 16090, at 3 (1969). The Department places the Petitioners on notice that Northern Indiana's authorization to operate as a gas company in Massachusetts shall expire as of the date of the consummation of the Preferred Merger, if the Preferred Merger is implemented.

I. Preferred Merger Versus Alternative Merger

While the Petitioners are seeking approval of both the Preferred Merger and Alternative Merger, they have expressed their preference for the Preferred Merger and request that the Department inform the SEC that the Department also favors the Preferred Merger (Exh. Cos.-B at 17; Petition at 3).

The Department favors the Preferred Merger. Under the Preferred Merger, the post-merger structure of Bay State would be consistent with the holding company structures that have been adopted by all of the investor-owned Massachusetts-based electric utilities, a number of investor-owned gas utilities, and are currently under consideration by other utilities. Eastern-Essex Acquisition at 76-77; D.P.U. 97-63, at 10; Berkshire Gas Company, D.T.E. 98-61 (pending before the Department). The Alternative Merger would make Bay State an operating division of Northern Indiana, a wholly-owned gas and electric subsidiary of NIPSCO Industries, a holding company. Under the Preferred Merger, Bay State would have its own books and records, capital and management structures, and board of directors (Exh. Cos.-A at 29-30). Therefore, the Department's statutorily-mandated review of specific company proposals would be more efficient under the Preferred Merger than the Alternative Merger, where Bay State would be operating as the Massachusetts division of Northern Indiana.

By way of example, G.L. c. 164, § 14 requires gas and electric companies to seek Department approval prior to the issuance of stock, bonds, coupon notes, or other evidences of indebtedness. Under the Preferred Merger, the Department's review of financing proposals filed by Bay State pursuant to G.L. c. 164, § 14, would be based on examining Bay State as a stand-alone entity or as a participant in a larger financing package prepared by NIPSCO Industries (Tr. 2, at 65-66). Under the Alternative Merger, the Department would have to examine each financing proposal of Northern Indiana, whether or not the financing had any effect on that company's Massachusetts division, in order to determine whether the particular proposal had an impact on Massachusetts operations (Tr. 2, at 66-67). As the Petitioners have noted, implementation of the Alternative Merger would require additional coordination between the Department and the Indiana Utility Regulatory Commission, thereby adding to the complexity of financial oversight (Tr. 2, at 67-68). Moreover, complexities would be created in the area of cost allocations between Northern Indiana's Indiana and Massachusetts operations (Exhs. AG 3-11; AG 3-12). Therefore, because of the efficiencies that would result from the Preferred Merger, the Department states its pronounced preference for the Preferred Merger over the Alternative Merger.

The Petitioners have also proposed an Alternative Merger (Tr. 2, at 68, 81-82;

Exh. Cos.-A, Sch. MTM-4, at A-1).[56] The Department has already spoken in favor of the Preferred Merger model and has noted that, with the exception of differing corporate structures, the remaining elements of the Preferred and Alternative Merger proposals are identical. If the Alternative Merger model is followed, Bay State (a gas company within the meaning of

G.L. c. 164, sec. 1, and a Massachusetts corporation) would merge not into Acquisition Company, a planned Massachusetts corporation, but, instead, into Northern Indiana, an existing gas and electric company incorporated in Indiana. The Alternative Merger would thus extinguish Bay State's corporate existence under Massachusetts law. The company would be converted into the Massachusetts operating division of the foreign corporation, Northern Indiana.

The Electric Restructuring Act, St. 1997, c. 164, § 189 ("Restructuring Act"), amended the definition of "gas company" in G.L. c. 164, § 1, to remove the requirement that a gas company be organized under the laws of the Commonwealth. It seems evident that the Legislature's removal of that restriction was intended to permit foreign corporations to act as gas companies in Massachusetts. The result was to allow operation by entities previously excluded from Massachusetts regulatory law and practice. The Restructuring Act contains, however, no further expression of legislative intent as to how regulation of such foreign corporations -- and certainly not foreign corporations with operating divisions in both Massachusetts and other

states -- is to be accomplished under or integrated into G.L. c. 164. Moreover, apart from requesting approval of the Alternative Merger proposal, the Petitioners developed no adequate record on how certain regulatory questions raised by that proposal ought to be addressed or how Bay State would conduct itself as an operating division of Northern Indiana.

There are important issues about regulating Bay State as an operating division of a foreign corporation. These issues include the nature and scope of Department regulation of Northern Indiana's capital structure, cost allocation between operating divisions,[57] and the coordination between this Department and the Indiana Utility Regulatory Commission. These and probably other issues may need to be defined, explored, and resolved in the interest of protecting Bay State ratepayers.

Having made those points, the Department provisionally approves the contingent Alternative Merger. If the Petitioners elect to follow that path, instead of the Preferred Merger, then the Petitioners must so inform the Department and must file with the Department

proposals -- with supporting legal argument -- for appropriate integration of the Alternative Merger's corporate and operating structure into the G.L. c. 164 framework. The Petitioners, either through the initial filing or through a Department investigation, must satisfy the Department that Massachusetts ratepayers' interest will not be impaired.

V. SUMMARY

The Department has evaluated the benefits and costs associated with the merger based on the following five factors: (1) effect on rates and the resulting net savings the merger; (2) effect on the quality of service; (3) societal costs; (4) acquisition premium; and (5) financial integrity of the post-merger entity.

The Department has found that approval of a five-year base rate freeze will benefit Bay State's ratepayers and will result in just and reasonable rates. Further, the Department recognized that the proposed merger could provide Bay State's ratepayers with savings in gas costs that would be unavailable absent the merger.

Concerning the proposed merger's effect on quality of service, the Department has ordered the continuation of the quality of service plan currently in effect to ensure that Bay State's ratepayers experience no degradation of service following the merger.

With respect to the societal costs of the proposed merger, the Department has found that the merger would not significantly affect Bay State's workforce.

Regarding the recovery of an acquisition premium, the Department has found that earnings dilution to Bay State's shareholders that results from the merger represents a cost that may and should be taken into consideration as part of the evaluation of the costs and benefits of the merger. The Department found that the proposed purchase price for Bay State's common stock and proposed exchange ratio are reasonable. Therefore, the Department accepted the Petitioners' estimate of $ 310,000,000 for the acquisition premium and has found it to be reasonable. However, the Department reminds the Petitioners that they are at risk for non-recovery of the premium if they fail to make the requisite showing of offsetting benefits.

Regarding the financial integrity of the post-merger entity, the Department has found that both Bay State and Northern Indiana are viable companies and that the merger would not adversely affect Bay State's financial integrity.

Based on our evaluation of the costs and benefits associated with the aforementioned factors, the Department finds that the public interest would be at least as well served by approval of the proposed merger as by its denial, i.e., that there is no net harm to ratepayers. Therefore, the proposed merger is consistent with the public interest. Accordingly, the Department hereby approves the Preferred and Alternative Merger Agreements and Rate Plan, subject to the directives contained herein, under the terms of G.L. c. 164, §§ 94 and 96.

VI. CONCLUSION

For decades, little or no acquisition or merger activity took place in the Commonwealth. Service territory maps of investor-owned electric and gas companies in Massachusetts, as a result, remain highly Balkanized.(58) Such geographic fragmentation suggests inefficiencies both from avoidable overhead and from limitations on utilities' ability to take market actions beneficial to customers -- especially in the area of gas purchasing, corporate finance, and staffing. Mergers and Acquisitions, D.P.U. 93-167A, sought to break with this disadvantageous status quo. Eastern-Essex Acquisition, D.T.E. 98-27, enunciated a clear Department policy in favor of suitably-framed consolidations. The Petitioners, however, filed shortly after the Eastern-Essex transaction came before the Department and thus could not have benefitted from perusal of the final order in Eastern-Essex Acquisition before making their filing.

While the proposal made in the instant docket has succeeded in securing Department approval under §96, the Petitioners' initial filing lacked the detail we expect to see in future §96 proposals. The logic of the initial filing had its strengths; but the filing's level of generality left important detail to be developed by the Department itself through discovery and evidentiary hearings. The Department would not want to repeat that onerous process.

Mergers and Acquisitions, D.P.U. 93-167A, at 7, had warned that a petitioner who expects to avoid an adverse outcome should not rest its case on mere generalities. The Department would not want future petitioners to see its approval of the instant proposal as a sign that this initial filing is a favored model for future §96 filings. Future filings, based on generalities, will not suffice to justify § 96 approval, including any requests for acquisition premium recovery. This reminder applies also to any future filing by the instant Petitioners to justify premium recovery. Rather, the Petitioners must demonstrate benefits that justify costs, including the cost of any acquisition premium sought.

VII. ORDER

Accordingly, after due notice, hearing and consideration, the Department

VOTES: That pursuant to G.L. c. 164, § 14, the issuance and sale by Acquisition Gas Company of 100 shares of common stock, $1.00 par value, to NIPSCO Industries in exchange for $100.00 is reasonably necessary for the purposes stated; and it is

ORDERED: That pursuant to G.L. c. 164, § 14, the issuance and sale by Acquisition Gas Company of 100 shares of common stock, $1.00 par value, to NIPSCO Industries in exchange for consideration of $100.00 is hereby approved and authorized; and it is

FURTHER ORDERED: That pursuant to G.L. c. 164, § 96, the Agreement and Plan of Merger by and among Bay State and NIPSCO Industries, dated as of December 18, 1997, and as amended and restated as of March 4, 1998, by and between Bay State and NIPSCO Industries is hereby approved; and it is

FURTHER ORDERED: That pursuant to G.L. c. 164, § 96, the merger of Acquisition Gas Company into Bay State Gas Company is hereby approved; and it is

FURTHER ORDERED: That pursuant to G.L. c. 164, § 94, the Rate Plan for Bay State Gas Company is allowed in part and denied in part, and that Bay State Gas Company, Northern Indiana Public Service Company and NIPSCO Industries design and file a Rate Plan in compliance with this Order; and it is

FURTHER ORDERED: That, upon consummation of the Preferred Merger of Acquisition Gas Company with and into Bay State Company, Acquisition Gas Company as surviving company shall have all rights, powers, and privileges, franchises, properties, real personal or mixed, and immunities held by Bay State Gas Company necessary to engage in all the activities of a gas utility company in all the cities and towns in which Bay State Gas Company was engaged immediately prior to the merger, and that further action pursuant to G.L. c. 164, § 21 is not required to consummate the merger; and it is

FURTHER ORDERED: That pursuant to G.L. c. 164, § 17A, under the Preferred Merger, an amendment to Bay State's debt pooling agreement to join NIPSCO Capital Markets, Inc. as a party to the Agreement is hereby approved; and it is

FURTHER ORDERED: That if, subject to the conditions contained herein, the Alternative Merger occurs, operation of Northern Indiana as a gas company is approved pursuant to G.L. c. 164, §§ 1 and 8A(a); and it is

FURTHER ORDERED: That Bay State Gas Company, NIPSCO Industries, Northern Indiana Public Service Company and Acquisition Gas Company shall comply with all directives contained herein; and it is

FURTHER ORDERED: That a copy of the journal entries, or a schedule summarizing such entries, recording the effect of the merger shall be filed with the Department upon consummation of the merger; and it is

FURTHER ORDERED: That the Secretary of the Department notify the Secretary of State of the issuance of stock and deliver a certified copy of this Order to the Secretary of State within five business days hereof; and it is

FURTHER ORDERED: That the Secretary of the Department notify the securities and Exchange Commission of the issuance of this Order under cover letter informing that agency of the Department's preference for the Preferred merger, and deliver to that agency a certified copy of this Order.

By Order of the Department,

_____

Janet Gail Besser, Chair

James Connelly, Commissioner

W. Robert Keating, Commissioner

Paul B. Vasington, Commissioner

Eugene J. Sullivan, Jr., Commissioner

1. The draft articles of organization for NIPSCO Acquisition Company identify the company as Acquisition Gas Company (Exh. DTE 1-7). The Petitioners stated that the latter name will be used when the subsidiary actually is incorporated (Tr. 2, at 84).

2. NIPSCO Capital acts as a financing agent for all of NIPSCO Industries' regulated and unregulated subsidiaries, with the exception of Northern Indiana, under the terms of an existing support agreement (Exhs. Cos.-B, Sch. MTM-2, at 26, 35; DTE 1-23; Tr. 2, at 75).

3. On June 25, 1998, the Union filed a letter in support of the Merger.

4. See note 6 below.

5. Through IWC, NIPSCO Industries indirectly owns Indianapolis Water Company and Harbor Water Corporation, plus three unregulated subsidiaries (Exh. Cos.-B at 4).

6. The Petitioners explain that while they have requested that the SEC approve the Preferred Merger, they note that the SEC may, as a condition of the Preferred Merger, require NIPSCO Industries to relinquish its status as an exempt holding company by virtue of Section 3(a)(1) of the Public Utility Holding Company Act of 1935 ("PUHCA") (Exh. Cos.-B at 16). Loss of the exempt status would, according to the Petitioners, impose significant reporting requirements on NIPSCO Industries, as well as possible restrictions on NIPSCO Industries' operations (Tr. 2, at 59-62). Because the Alternative Merger does not require SEC approval, the Petitioners request that the Department approve the merger under both the Preferred Merger and the Alternative Merger, so that the merger may be consummated under the Alternative Merger if the SEC requires NIPSCO Industries to relinquish its exempt status as a condition of approval of the Preferred Merger (Exhs. Cos.-A at 29; Cos.-B at 16). The Petitioners made the request that the Department inform the SEC of a preference for the Preferred or the Alternative Merger plan in advance of our final order in D.T.E. 98-31

(Exh. Cos.-A, Tab A at 4). Of course, such a prejudgment in advance of a final Order is not a request that the Department could readily grant. But we do state here that the Preferred merger is favored by the Department and will so inform the SEC. See § VII below.

7. The actual number of NIPSCO Industries' shares to be issued in exchange for Bay State's common stock would be determined by dividing the cash price of $40 per share by the average NIPSCO closing price for the twenty trading days before the second trading day before the consummation of the merger (the "Effective Time" as described in article 1.4 of the merger agreement (Exh. Cos.-B, Sch. MTM-4, at A-3).

8. Earnings sharing refers to a sharing of above- or below-average profits between the utility and ratepayers. Under earnings sharing, the regulator sets a benchmark return using traditional Rate of Return techniques. The regulator then establishes the level(s) of return above and below the benchmark at which sharing would be triggered, and the distribution of those above- or below-average earnings between the utility and ratepayers. NYNEX, D.P.U. 94-50 at 186 (1994).

9. In Bay State Gas Company, D.P.U. 97-97 (1997), the Department approved a settlement agreement between Bay State and the Attorney General which provided for two annual base rate increases of up to $1.8 million per year, recovery of an additional $1.6 million for expenses related to customer choice pilot programs through the Distribution Adjustment Cost Clause, and the introduction of both an ESM and service quality index.

10. According to the Petitioners, the actual premium level attributable to Bay State's stand-alone operations is dependent upon a number of factors, including a review of Bay State's accounts, the final costs of the transaction, and the elections made by Bay State's shareholders under the cash option feature (Tr. 1, at 23-26; Tr. 2, at 123). The Petitioners agreed that for purposes of the proceedings, they would accept the Attorney General's estimate that Bay State's stand-alone share of the total acquisition premium would be 69.7 percent, or $216,096,000 (Exh. DTE-1, Sch. 1; Tr. 1, at 24-26).

11. Those transaction costs being incurred by Bay State are expensed in accordance with GAAP (Exh. AG 2-14).

12. The Department issued its Order in Eastern-Essex Acquisition, D.T.E. 98-27 (1998) on September 17, 1998, which was after hearings were completed and briefs had been filed in this case.

13. The Department notes that a finding that a proposed merger or acquisition would probably yield a net benefit does not mean that such a transaction must yield a net benefit to satisfy G.L. c. 164, § 96 and Boston Edison, D.P.U. 850.

14. Thus, Mergers and Acquisitions removed the per se bar to recovery of acquisition premiums and treated them as just another kind of costs to be reckoned in the balancing of costs and benefits required by G.L. c. 164, § 96 and Boston Edison Company, D.P.U. 850.

15. In their Brief, the Petitioners indicated, for the first time, a willingness to implement a ten year rate freeze (Petitioners Brief at 35). Due to the lack of record evidence needed to approve or deny such a request, the Department will not consider this proposal.

16. The Petitioners use the term DACC in place of Local Distribution Adjustment Clause ("LDAC"). The LDAC is a mechanism that allows an LDC to recover, or credit on a fully reconciling basis, costs that have been determined to be distribution-related costs but not included in base rates. Such costs include demand side management costs, environmental response costs associated with manufactured gas plants, and Federal Energy Regulatory Commission Order 636 transition costs. The LDAC is applicable to all firm customers (both sales and transportation). To maintain uniformity of terminology among the LDCs, the Department directs the Petitioners to use the term LDAC in the future.

17. As noted above, the Petitioners define exogenous factors as changes in tax laws, accounting principles, and regulatory, judicial, or legislative mandates (Exh. Cos.-A, at 19). The Petitioners do not indicate how such exogenous effects might be influenced by the structure envisioned by the Alternative Merger, if adopted. If Bay State were to become an operating division of a foreign corporation, Indiana-driven effects could not be visited upon Massachusetts ratepayers. See discussion at end of Section IV(I).

18. The Petitioners state that sometime before the end of Bay State's current rate plan on October 31, 1999, Bay State will submit proposed refinements to the quality of service standards and targets contained in that rate plan (Exh. Cos.-A at 18; Tr. 2, at 161).

19. The Petitioners calculate the $31 million savings in incremental revenues during the five-year rate freeze by assuming $1.8 million in cumulative base rate increases ($27 million) plus $800,000 per year in unbundling costs ($4 million) (Petitioners Brief at 31).

20. G.L. c.164, § 1E(b) sets forth certain requirements that pertain to performance-based regulation plans.

21. Bay State's recent rate case history is as follows: (1) Bay State Gas Company, D.P.U. 1122 (1982) ($2.1 million increase); (2) Bay State Gas Company, D.P.U. 1535 (1985) ($5.5 million increase); (3) Bay State Gas Company, D.P.U. 89-81 (1989) ($12.4 million increase); (4) Bay State Gas Company, D.P.U. 92-111 (1992) ($11.5 million increase); (5) Bay State Gas Company, D.T.E. 97-97 (1997) ($3.6 million increase over two years).

22. The Petitioners' contention that the actual benefit of the rate freeze would be a savings of $31 million for ratepayers is based on the assumption that Bay State would be entitled to -- and that the Department would approve -- $1.8 million per year in cumulative base rate increases, as well as the annual recovery of $800,000 in third-party unbundling costs. The current rate plan expires on October 31, 1999; and rate increases, allowed under the current plan, apply to the cost of service for that two-year settlement period and may not extend beyond that date. The Petitioners have not provided adequate support in the record for the validity of assuming that the conditions of the settlement would hold into the future. Therefore, the Department does not accept the Petitioners' savings estimate of $31 million.

23. Performance Based Rate plans excepted.

24. Bay State Gas Company, D.P.U. 92-111, at 281-282 (1992).

25. The pushed down equity is the balance sheet effect associated with an acquisition premium under the purchase accounting method. Under purchase accounting, the acquisition premium would represent an intangible asset on the asset side of the balance sheet. The acquisition premium must also appear on the equity side of the balance sheet -- increasing the equity balance by the same amount of the acquisition premium as recorded on the asset side of the balance sheet. Including the acquisition premium in the common shareholders' equity balance substantially increases the denominator in the calculation of ROE. The net effect of including this amount in the common equity balance would significantly reduce the ROE (Exh. AG 3-1 (Bay State Gas Company, D.P.U. 93-167 Supp. Comments, Question 3, at 1)). The effect is expressed formulaically thus:

$$\text{ROE} = \frac{\text{Net income - preferred shareholder dividends}}{\text{Average common shareholders' equity}}$$

26. The Petitioners project that the annual benefits associated with bundled off-system sales, interruptible sales, and capacity release credits could result in an incremental increase of $1.8 - 3.6 million per year as a result of joint management efforts depending on the regulatory environments under which the Petitioners operate

(Exh. AG-2-16 (Supp.) at 1).

27. The Customer-Choice Program is a pilot program by Bay State to identify and evaluate the mechanisms that affect a competitive gas supply market (Exh. Cos-1, at 10-11).

28. Northern Indiana purchases approximately 85 percent and Bay State purchases approximately 40 percent of their respective system supplies from the on-shore and off-shore Texas and Louisiana producing regions (Exh. AG 2-16 (Supp). at 1). Moreover, both companies expect to purchase more Canadian supplies (id.). According to the Petitioners, joint purchasing of these supplies would lead to greater economies and efficiencies (id.).

29. Bay State and Northern Indiana have contracted capacity on Tennessee Gas Pipeline (Exh. AG 2-16 (Supp.). Further, the two companies hold capacity on 16 interstate pipelines of which nine intersect and form industry-recognized trading hubs (id. at 1).

30. Weather normalization is an adjustment for weather based on a comparison of test year degree days to twenty-year average degree-day data obtained from an official weather data source. Fall River Gas Company, D.P.U. 750, at 8 (1981).

31. Decreasing net income would result in a smaller ROE. The opposite occurs during a year with warmer than

normal temperatures.

32. The Settlement contains the following service quality measures and benchmarks: (1) customer survey responses indicating that Bay State met or exceeded customer expectations -- 94 percent in fiscal year ("FY") 1998, and 94.5 percent in FY 1999; (2) service appointments met on the day scheduled -- 94 percent in FY 1998, and 95 percent in FY 1999; (3) no more than 1.4 customer complaint cases per 1,000 customers, using the Department's Consumer Division statistics for both FY 1998 and FY 1999 (with a ten percent no-penalty bandwidth); (4) lost time incidents per 100 employees -- current three-year average not exceeding the previous year's three-year average; (5) response time to odor calls in one hour or less -- 95 percent for both FY 1998 and FY 1999; (6) current year of main and service damage incidents due to third parties -- not exceeding the previous year's three-year average; (7) emergency, and service and billing calls answered within 30 seconds -- 95 percent for both FY 1998 and FY 1999, and 80 percent for FY 1998 and FY 1999, respectively; and (8) actual on-cycle meter readings -- 88 percent in FY 1998 and 89 percent in FY 1999. Failure to comply with any one of these goals would carry a maximum penalty of $250,000 per measure or a maximum penalty of $2.0 million annually. For each measure, one-fourth of the maximum penalty would be assessed for each percentage point, or any portion thereof, that Bay State's performance falls short of the target. D.P.U. 97-97, at 4-5.

33. The Department directs companies filing requests for approval of mergers or acquisitions to include a service quality plan that is designed to prevent degradation of service following the merger. This directive reaffirms the importance of maintaining and improving service quality to customers. Eastern-Essex Acquisition at 33; Mergers and Acquisitions at 8-10.

34. The acquisition premium is a function of the purchase price of $40 per share and the book value of the approximately 13,750,000 shares that the Petitioners estimate will be outstanding as of the consummation of the merger (Exh. AG 2-9). Subtracting the book value of approximately $240 million from the total purchase price of $550 million results in the $310 million acquisition premium (id.).

35. The Petitioners state that the acquisition premium must be recorded on Bay State's consolidated books, in accordance with the guidelines set forth by the SEC in Staff Accounting Bulletin 54 (Exh. AG 2-14; Tr. 2, at 91-93).

36. As interpreted by the SEC, the Treasury Stock Condition requires that each of the combining enterprises reacquires shares of voting common stock only for purposes other than business combinations, and no enterprise reacquires more than a "normal" number of shares between the dates the plan of combination initiated and consummated (Exh. AG 2-13; Tr. 2, at 52-53, 55). Since 1989, NIPSCO Industries has had a stock repurchase program in effect, which has resulted in the repurchase of approximately 44 million shares of NIPSCO Industries common stock (Exh. Co.-B, Sch. MTM-2, at 46). A significant number of these repurchased shares resulted from NIPSCO Industries' acquisition of IWC in 1997 (Exh. Co.-B, Sch. MTM-2, at 46).

37. APB 16 is a subsection of GAAP that specifies the rules to follow when entering into a business combination (Exh. AG 2-13). APB 16 states that a business combination may be recorded under pooling of interests accounting when it meets certain specified criteria, otherwise it must be recorded as a purchase (Exh. AG 2-13).

38. The SEC has defined the "normal" number of shares that can be repurchased under APB 16 as no greater than ten percent of the total number of shares to be issued under the business combination under review (Tr. 2, at 52-53, 55). The Petitioners estimated that, assuming 20 million NIPSCO Industries shares to be issued in conjunction with the merger, no more than two million shares could be held as repurchased shares and still meet the Treasury Stock condition (id. at 55). During 1997 alone, NIPSCO Industries repurchased approximately 25.2 million shares, most of which were associated with the IWC acquisition (Exhs. AG 1-3, at 43; Cos.-B, Sch. MTM-2, at 46).

39. -

40. The Attorney General's own witness agreed that the SAB 54 is dispositive of the need to reflect the acquisition premium on Bay State's books (Tr. 3, at 69).

41. The Attorney General's argument that Petitioners should be precluded from recording the merger using purchase accounting simply because Bay State commented favorably on the benefits of pooling of interests accounting in Mergers and Acquisitions is without merit. The Department construes Bay State's comments in that proceeding as a general indication of support of the use of pooling of interests accounting, not as proposing the use of pooling of interests accounting for all mergers and acquisitions.

42. Additionally, in Eastern-Essex Acquisition, the Department found that Eastern Enterprise's payment of 2.36 times the book value for Essex County Gas Company was reasonable. Eastern-Essex Acquisition at 65. It is, of course, possible that a future

§ 96 petition might seek recovery of an excessive premium, unwarranted by market evidence and offsetting benefits.

43. The Department expects that the Petitioners will begin to amortize the acquisition premium during the five-year term of the rate freeze and will not seek to recover any of the amortization of the acquisition premium from that five-year period at the end of the rate freeze. In other words, the Petitioners may not defer recovery of the entire acquisition premium to the 35 post-rate freeze years in which such recovery is allowed.

44. Consequently, the Department finds it premature to consider the Attorney General's proposal to assign all of the acquisition premium to Bay State's unregulated operations.

45. The Department took administrative notice of Bay State's Annual Returns to the Department for the years 1993 through 1997 pursuant to 220 C.M.R. § 1.10(3) (Tr. 3, at 38-39).

46. Long-term refers to periods of more than one year after the date of issuance.

G.L. c. 164, § 16.

47. The net plant test is derived from G.L. c. 164, § 16.

48. The Petitioners did not seek to include Northern Indiana as a participant in Bay State's funds pooling agreement (Petition at 6-7).

49. G.L. c. 164, § 8A(a) provides, in pertinent part, that a gas company shall not be authorized to engage in the business of an electric company and an electric company shall not be authorized to engage in the business of a gas company unless the Department, after notice and public hearing, certifies to the state secretary that the Department deems the public convenience will be promoted thereby.

50. Under the Alternative Merger, Northern Indiana would be the surviving company (Exhs. Co.-A at 28-29; Co.-B, Sch. MTM-4, at A-1).

51. An earlier version of G.L. c. 164, § 23, governed the acquisition of electric systems by gas companies, and the acquisition of gas systems by electric companies. The provisions of G.L. c. 164, § 23, were stricken and the subject matter replaced, in part, by G.L. c. 164, § 8A, pursuant to St. 1973, c. 860, §§ 8 and 13.

52. An Act Relative to Restructuring the Electric Utility Industry in the Commonwealth, Regulating the Provisions of Electricity and Other Services, and Promoting Enhanced Consumer Protection Therein. St. 1997, c. 164.

53. Section 189 of St. 1997, c. 164 changed the definition of "gas company" and "electric company" found in G.L. c. 164, § 1, so that a gas or electric company need not be a domestic Massachusetts corporation, provided such corporation is organized for the purpose of making and selling, or distributing and selling, gas and electricity within Massachusetts. Currently, Northern Indiana does not have any authority to operate within Massachusetts (Exh. AG 1-1, Sec. 4.3, at 3).

54. The Department notes that such a vote may not be necessary if the Preferred Merger is ultimately implemented (Tr. 2, at 83-84).

55. General Laws c. 156B, § 11, in relevant part, permits corporations to assume any name that has not been used by a corporation in current operation or had been in operation during the prior three years, unless written consent of the preexisting corporation is filed with the state secretary. The Department presumes that Bay State's assent for Northern Indiana to operate in Massachusetts under the Bay State name would readily be obtained.

56. The Department recognizes the logic in this case for the Petitioners to offer "preferred" and "alternative" merger structures in order to meet the requirements imposed by other government agencies. However, presenting alternative proposals is not an efficient way of litigating a case and should be introduced only when absolutely necessary. The Department will require companies to demonstrate this necessity in the future.

57. Bay State's last fully adjudicated (i.e., not resolved by settlement) rate case was in 1992. Bay State Gas Company, D.P.U. 92-111 (1992). There currently is no obvious answer to the question of whether the cost of service findings in that case would suffice to establish Bay State's operating costs as an operating division of Northern Indiana.

58. For example, and by way of contrast to Massachusetts' situation, Northern Indiana's service territory of 12,000 square miles (Exh. Cos.-A, at Tab B, at 3) is nearly half again the size of the entire Commonwealth (8257 square miles, including all embayments and sounds, Merriam-Webster's New Geographical Dictionary at 738 (1984).

Filed Session of December 16, 1998

CASE 98-W-1192

Approved as Recommended
and so Ordered
By the Commission

DEBRA RENNER
Acting Secretary

Issued & Effective January 8, 1999

STATE OF NEW YORK
DEPARTMENT OF PUBLIC SERVICE

December 7, 1998

TO: THE COMMISSION

FROM: GAS AND WATER DIVISION - WATER RATES SECTION
OFFICE OF ACCOUNTING AND FINANCE

SUBJECT: CASE 98-W-1192 - Joint Petition of AquaSource Utility, Inc. and Wild Oaks Water Company, Inc. for Approval of the Transfer of all of Wild Oaks Water Company, Inc. stock to AquaSource Utility, Inc.

SAPA: 98-W-1192SA1 - Published in State Register on September 2, 1998.

SUMMARY OF
RECOMMENDATION: That the petition be approved subject to the conditions described in this Order.

Summary

By joint petition dated August 18, 1998, AquaSource Utility, Inc. (AquaSource or ASI) and Wild Oaks Water Company, Inc. (Wild Oaks) request Commission approval, pursuant to Public Service Law §89-h, for ASI to acquire Wild Oaks' stock. Wild Oaks provides metered water service to 188 customers in Goldens Bridge, Town of Lewisboro, Westchester County. Wild Oaks also provides public fire protection service to the Goldens Bridge Fire Department and a private fire protection customer. Wild Oaks is a relatively well run system that provides safe and

adequate service, but will shortly face large expenditures for repair of its storage tank and corrosion control equipment. Currently, base annual residential bills are approximately $560 and Wild Oaks estimates that these projects could result in significant surcharges for several years.

ASI has committed to operate this system more efficiently, perform the above noted and necessary system improvement work, and, operate under an 11 year price cap plan. Under the plan the existing surcharge, which has averaged $30 per customer during the last three years, will be eliminated, rates will be frozen for four years, and in the fifth through eleventh years rates will be increased by an inflation based escalator.

Staff has reviewed the ASI proposal, believes that it is in the public interest, and recommends approval of the transfer contingent on the terms discussed herein.

Background

Wild Oaks currently provides safe and adequate service, but must shortly repair and paint its water storage tank, which it estimates will cost $100,000. Wild Oaks' wells are also due for periodic rehabilitation within the next few years and the Department of Health (DOH) requires that equipment for corrosion control be installed to enable the system to meet water quality standards. Wild Oaks has an escrow account for extraordinary maintenance expenses, that it could use to fund the corrosion control work by surcharging customers after the fact. However, it would have to fund the other projects by means of additional surcharges prior to the start of work. These new projects could increase the current annual customer base bill of $560 by $500 per customer per year for several years.

ASI is a wholly-owned affiliate of DQE[1/]. AquaSource owns water and wastewater utilities, construction and engineering

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1/ DQE, Inc., (formerly Duquesne Power and Light Company) is a Pennsylvania-based electric, transmission and distribution and energy services company with assets of more than $4.6 billion and annual revenue in excess of $1.2 billion.

companies, system leasing and fabrication businesses and contract operation services. Since its formation, ASI has acquired 24 water utilities serving about 100,000 customers in two states. ASI intends to become a significant player in the private water business in New York State and elsewhere and is willing to assume the considerable commitment to make Wild Oaks a long-term, viable water system.

The Petition

ASI has entered into a contract to purchase all outstanding stock of Wild Oaks for $436,303. The purchase price is about 273% of the current $117,000 rate base for Wild Oaks. However, the level of rate base for small water systems is generally not truly representative of the level of actual plant investment because of the high level of contributed plant from real estate developers. In addition, ASI will place $75,000 in an escrow account to be apportioned and paid to ASI and/or the current owner of Wild Oaks, as determined by the estimated cost to repair or replace the company's sole storage tank, and install the corrosion control treatment required by DOH. Although customer growth is not expected, ASI will pay Wild Oaks' current owner an additional $1,739 (less connection costs) for any new customer joining the system on or before December 31, 2001.

ASI stated that it would use equity (and possibly long term debt) financing to help avoid the large surcharge rate increases that customers would face if Wild Oaks were to do these projects. Ownership by ASI will result in more efficient financing of any improvements, compared to current ownership.

ASI indicates that it has access to and is willing to commit the funds necessary for operation and capital improvements. ASI requests that the Commission not take any action to reduce rates and allow ASI to retain for itself the efficiencies it attains. According to ASI, retaining the operating efficiencies will compensate it for the increased investment base.

Customer Notification

Wild Oaks and ASI have sent notices to customers introducing ASI, informing them about the proposal, describing the problems facing the system and explaining how ASI can better respond to these issues. ASI indicated its goal is to provide a reliable supply of safe, clean water and to maintain the highest level of customer service possible at the lowest practical cost. ASI also outlined its plan to consolidate neighboring systems to increase operating efficiencies and provide better service than separate small companies.

The customers were informed in the notice of the need for Commission approval and asked to contact Wild Oaks if they had any questions or comments. To date, Wild Oaks has not received any inquiries. Further, the Commission's Consumer Services Division has not been contacted by any customer about the stock transfer or any other issues during the past year.

Discussion

Many of the 400 Public Service Commission regulated water systems are small and do not have the financial capability to cope with major repairs and other stresses of business. Some of the small companies are in poor condition and long term service is in jeopardy. Occasionally, some municipalities have been able to take over small troubled companies, but usually only as a last resort, and typically after long periods of poor service and customer anguish. To address this situation, the Commission issued its Acquisition Incentive Policy[1/]. This policy statement indicates the Commission's willingness to encourage consolidation and acquisitions of small companies by non-traditional ratemaking approaches (e.g., a return premium, recognizing acquisition premiums in rate base, bringing rates of the acquired company up to regional rates, and accelerated write-offs of acquisition costs).

1/ Case 93-W-0962 -- Statement of Policy on Acquisition Incentive Mechanisms for Small Water Companies ("AIM Policy"), issued August 8, 1994.

ASI intends to use its financial ability to make system improvements at its acquisitions to ensure their long-term viability. In the case of Wild Oaks, ASI will invest the necessary funds to rehabilitate the water storage tank. ASI's willingness to takeover small and often troubled water systems is consistent with the Commission's goal of consolidating small water companies. ASI has petitions before the Commission seeking approval of the acquisition of Cambridge Water Works Company and Hudson View Water Works Corp.

Staff discussions with ASI have resulted in an ASI proposal to freeze rates for four years (through 12/31/02, see Appendix A). After the initial rate freeze and up to the eleventh year, rates would be allowed to increase at an escalator equal to the Gross Domestic Product (GDP) annual inflation rate minus 25% GDP as a productivity factor. During this period, if certain expenses increase at an annual rate 5% greater than the allowed annual escalator[1/], ASI could file for a rate increase but would lose the ability to revert to the GDP based rate escalator. While the Commission retains its authority under the Public Service Law to ensure just and reasonable rates for water service over the term of the rate plan, as has been noted in other cases, we recognize that allowing ASI the potential for retaining the operational savings in lieu of an acquisition premium is a departure from traditional rate of return ratemaking methodology.

The productivity factor will be open to upward renegotiation (e.g. minus 30% of GDP) in the event that ASI buys additional companies, which provide added economies to all ASI companies. The expectation would be that some of the additional efficiencies would be shared between ratepayers and ASI.

[1/] If the aggregate of certain unavoidable expenses (such as power, chemicals, taxes, testing costs, and the depreciation and return components of extraordinary capital additions) rise more than 5% above the escalator, a rate reopener would be allowed. However, one-half of new customer revenues would be netted against the increased costs.

Finally, ASI will not book any acquisition premium, but will be allowed to keep any realized operational savings for the first 11 years.

ASI's proposal will alleviate the rate impact of high surcharges that customers would likely encounter if Wild Oaks were to do the system repairs and improvements itself. Moreover, because long term financing is not an option for Wild Oaks, ownership by ASI will result in reduced financing costs to customers for any future improvements as compared to current ownership.

It appears that ASI should be able to achieve economies of scale in both operations and financing. Accordingly, customers will be paying no more, and most likely less, under ASI's ownership than they would be under the current ownership. And, since ASI has pledged to make the required system repairs, staff believes the transfer is in the public interest.

This memo has been reviewed by Nancy Tourville of the Office of Consumer Affairs and David Van Ort of the Office of Counsel.

Recommendation

It is recommended that:

The Commission approve the transfer of the Wild Oaks Water Company, Inc. stock to AquaSource Utility, Inc., conditioned on the following provisions related to the future ratemaking:

1. Cancel Second Revised Leaf No. 33A related to the existing escrow account by January 15, 1999.

2. Existing base rates shall remain in effect for a minimum of four years (through 12/31/02).

3. After the initial four year rate freeze (through 12/31/02), ASI will be allowed to increase rates by an escalator based upon the increase in the GDP inflator minus 25% of the GDP for anticipated productivity savings. However, the 25% GDP productivity factor will be open to

renegotiation upward as described in the body of this order.

4. If the aggregate of certain unavoidable costs (power, chemicals, taxes, testing costs, and the annual expenses of depreciation and return components of extraordinary capital additions) increase by more than 5% above the escalator, ASI will be allowed to apply for a rate reopener, subject to the provisions described in the body of this Order.

Respectfully submitted,

Bruce E. Alch
Principal Engineer
Gas & Water Division

Brian Summers
Associate Utility Financial Analyst
Office of Accounting & Finance

APPROVED:

Arthur Gordon
Chief, Water Rates Section
Gas and Water Division

Richard Ansaldo
Chief, Office of Accounting & Finance

Rate Plan for AquaSource Acquisition
of Wild Oaks Water Company, Inc.

- Rate Freeze
  - ASI would hold rates constant to 12/31/02 (4 year freeze).
- Rate reduction
  - ASI would reduce rates by eliminating the existing O&M surcharge.
- Improved Service
  - ASI would invest in the repair and maintenance of Wild Oaks Water storage facility without increasing current rates, except for the escalator and extraordinary reopener clauses discussed below.
- GDP based Escalator in "Out Years"
  - In the fifth through eleventh years if the GDP inflator is greater than zero, rates would increase by an escalator (the GDP inflator less 25% of the GDP for a productivity offset), e.g., GDP deflator of 2% results in an escalator of 1.5% and 8% GDP results in 6% escalator. Prior year actual GDP will be used to set subsequent year rates.
  - The minus 25% of GDP as a productivity offset will be open to renegotiation upward (e.g., minus 30% of GDP, but no greater than 50% of GDP) in the event that ASI buys additional companies, which provide for added economies to all ASI companies. The intent would be to share some of the additional economies between ratepayers and ASI.
- Rate reopeners for extraordinary expense increases
  - If certain unavoidable costs (power, chemicals, taxes, testing costs, and the depreciation and return component of extraordinary capital additions), increase in aggregate, by more than 5% above the escalator, a rate reopener would be allowed. However one-half of new customer revenues would be netted against the increased costs. If reopener is used, ASI cannot revert to the escalator option in remaining years.

CERTIFICATE OF SERVICE

Boyd J. Springer, an attorney, hereby certifies that he served copies of the "Initial Brief" and "Case Supplement" of Illinois-American Water Company on the individuals shown on the attached Service List, via electronic mail and Federal Express next day delivery on Friday, February 23, 2001.

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